

— **STATEMENT OF DETERMINATION AND ORDER** —

OF THE

SECRETARY OF FOOD AND AGRICULTURE

*REGARDING PROPOSED AMENDMENTS
TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK
THAT ADDRESS THE CLASS 1 PRICING FORMULA AND COMMODITY REFERENCE PRICE*

BASED UPON A PUBLIC HEARING HELD ON JANUARY 31, 2000

Signed in the Office of the Secretary
Tuesday, March 21, 2000

SUMMARY OF DETERMINATIONS

A duly noticed public hearing was held by the Department of Food and Agriculture (Department) on January 31, 2000, to consider adjustments to the pricing formula used to calculate minimum farm prices for Class 1 milk. At that hearing, testimony and evidence were introduced into the hearing record regarding proposed adjustments to the Class 1 formula. Additional testimony was collected through submissions of briefs following the close of the hearing. In general, testimony and evidence received referenced the implemented changes as of January 1, 2000 in federal milk marketing orders as the basis for the proposals submitted.

In weighing the testimony and evidence on the hearing record, the Department has made adjustments to California's Class 1 pricing formula to improve alignment with similar prices in neighboring states. These adjustments include:

- Using the higher of a Commodity Reference Price calculated based on butter and nonfat dry milk or cheese and whey butter,
- A shorter data collection window for the calculation of the Class 1 price
 - For butter and cheese, the applicable dates span from the 26th of the second prior month to the 10th of the prior month.
 - For nonfat dry milk, the two most recent weekly price reports available to the Department as of the 10th of the prior month will be used.
- The manufacturing cost allowance and freight adjuster in the Class 1 pricing formula will be replaced with a fixed adjuster of 10 cents per pound.
- Decrease the Commodity Reference Price differential from \$0.494 to \$0.464 per hundredweight.

Using data from October 1998 to March 2000, the total effect of these amendments would have increased whole milk prices an average of \$0.51 per hundredweight compared to the current formula projected backward. This increase closely follows the farm price increases that were implemented January 1, 2000 in surrounding states as a result of changes to the federal milk marketing order pricing system. The amendments would have increased the January, February and March 2000 whole milk prices by \$0.82, \$0.88 and \$1.38 per hundredweight, respectively.

These amendments will increase the minimum farm price dairy processors must pay for milk received from dairy producers. These changes may, or may not, affect the wholesale and retail prices of milk, which are not regulated by the State and are determined by individual firm's pricing policies.

Report Background and Layout

The determination to make amendments to the Stabilization and Marketing Plans for Northern California and Southern California (Plans) is based on evidence received into the Department of Food and Agriculture's hearing folder. The folder includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held January 31, 2000 and written post-hearing briefs.

- Introduction..... Page 3
- Review of Previous Class 1 Hearings Page 4
- Summary of Testimony Received Page 6
- Analysis of the Hearing Record Page12
- Summary of Determinations..... Page 26
- Effects of Panel Recommendations..... Page 26
- Summary of Class 1 Pricing Formulas Page 27
- Findings of the Department. Page 28
- Order of the Secretary Page 29

INTRODUCTION

California Food and Agricultural Code Section 61801, *et sec.*, provides the authority, procedures and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of Milk Stabilization and Marketing Plans for Market Milk (Plans).

The Department held a public hearing on Monday, January 31, 2000 in Sacramento, to consider amendments to the Plans. The Department called the hearing after receiving a petition submitted jointly by the Alliance of Western Milk Producers and Western United Dairymen. The hearing was limited to amendments to the Class 1 pricing formula and the Commodity Reference Price formula. One alternative proposal, submitted by the Dairy Institute of California, was received by the January 5 deadline.

A total of eleven witnesses testified excluding the Department's witness. Witnesses appeared on behalf of the following organizations:

- Dairy Institute of California (processor trade association),
- Alliance of Western Milk Producers (producer cooperative trade association)
- Western United Dairymen (producer trade association),
- Milk Producers Council (producer trade association),
- Security Milk Producers Association (dairy cooperative)
- Humboldt Creamery Association (dairy cooperative)
- Crystal Cream and Butter Company (fluid milk processor)
- Super Stores Industries (fluid milk processor)

A summary of the state of the dairy industry in California and in the U.S. can be found in the background material distributed at the pre-hearing workshop on January 12, 2000 and at the hearing on January 31, 2000. The background document also contains public policy considerations and statutory criteria for establishing and amending Stabilization and Marketing Plans and the Pooling Plan.

REVIEW OF PREVIOUS HEARINGS

Regarding Class 1 Pricing Formula and the CRP Formula

August 2, 1990

A hearing was called to consider changes to the Class 1 pricing formula. Two changes were made as a result of the hearing. First, value was shifted from fat (decreased by \$0.1430 per pound) to SNF (increased by \$0.0424 per pound) and fluid (increased by \$0.0015 per pound). Second, the CRP was made a temporary snubber for the Class 1 pricing formula during the period October 1, 1990 through January 1, 1991.

March 31, 1993

This hearing was convened to consider alternatives to the Class 1, 2 and 3 pricing formulas. The changes were made to the Class 1 pricing formula. First, for the 14-month period June 1993 through July 1994, the current Class 1 pricing formula was replaced by the formula using only the CRP. Second, the CRP was permanently altered by the inclusion of Grade B (whey) butter price and yield factors. Third, value was shifted from fat (decreased by \$0.1428 per pound) to SNF (increased by \$0.0230 per pound) and fluid (increased by \$0.0023 per pound). No changes were made to the Class 2 and 3 pricing formulas.

September 30, 1993

As a result of a hearing held September 30, 1993, to consider alternatives to the current Class 1, 2, and 3 farm pricing formulas, the following changes were made. Two changes were made to the Class 1 pricing formula. First, the current Class 1 farm pricing formulas was permanently replaced by a formula using only the CRP. Second, a base price increase of approximately \$0.84 per hundredweight was combined with shift from fat (decreased by \$0.1428 per pound) to SNF (increased by \$0.0569) and fluid (increased by \$0.0096). The Class 2 and 3 differentials were increased \$0.01 per pound for fat and \$0.02 for SNF for a combined increase of \$0.21 per hundredweight.

April 21, 1995

As a result of the hearing, a temporary \$0.13 per hundredweight increase in the Class 1, 2, 3, 4a and 4b prices was established. The increase was a fixed \$0.0107 per pound of both fat and SNF. The temporary increase was operational from June 1995 through January 1996.

August 9, 1996

This hearing addressed the issue of milk price alignment using surrounding states as references. The Department determined that California Class 1 price was too high relative to other adjoining states and was encouraging importation of out-of-state milk into California. The Class 1 pricing formula was revised by calculating the CRP in a different manner. For the 6-month period

October 1996 through March 1997 the CRP was the simple arithmetic mean of the two alternative calculation methods — Cheddar cheese & whey butter or butter & NFDm.

February 5 and 7, 1997

These two hearings were held to address milk price alignment with other states. The following changes were made to correct the misalignment.

1. Class 1 prices were frozen at the February/March 1997 level for the April/May 1997 pricing period;
2. CRP in the future will be based on Cheddar cheese prices without use of the “higher of”;
3. CRP will be based on a single (current) month;
4. Shift value from SNF back to fat;
5. Reduce the value of the fluid component in the Class 1 price;
6. Shift value from fat to fluid component in the Southern California Marketing Area.

April 21, 1997

The National Cheese Exchange (NCE) was being terminated, and a cheese exchange was being established at the Chicago Mercantile Exchange (CME). The old pricing formulas for both the Class 4b price and the CRP used NCE cheese prices. As a result of this hearing, both formulas now reference CME cheese prices.

May 8, 1998

The CME announced that it would no longer trade Grade B butter at the Exchange. A hearing was held to consider the best indicator of the value of whey butter. As a result of the hearing, the CRP formula uses the simple average CME Grade AA butter price less ten cents (\$0.10).

September 21, 1999

This hearing was called to address milk price alignment with other states. To correct the misalignment, the base price in the Class 1 pricing formula was lowered by \$0.57 per hundredweight (whole milk) and monthly pricing replaced bimonthly pricing. The allocation of value to milk components was changed such that the Class 1 fat price is priced directly using the CME Grade A butter price with deductions for freight and manufacturing costs, and solids-not-fat and the fluid carrier were priced as residuals.

LAYOUT OF SUMMARY OF TESTIMONY

For each person submitting evidence into the hearing folder, their name, organization represented, type of organization and sources of evidence presented is given before the summary of their evidence. There are five possible sources of evidence:

- Petition for a hearing (**Petition**)
- Alternative proposal (**Alternative**)
- Oral testimony with questions and answers before Hearing Panel (**Testimony**)
- Written exhibit submitted prior to close of hearing (**Exhibit**)
- Post hearing brief submitted after the close of hearing (**Brief**)

SUMMARY OF TESTIMONY

J. Tillison — Alliance of Western Milk Producers (Alliance), a producer cooperative trade association and

*J. Goold — Western United Dairymen (Western), a producer trade association, evidence based on **Petition, Testimony, Exhibit and Brief***

- ❖ Commodity Reference Price (CRP) higher of Block Cheese/Whey Butter or Butter/Powder
 - Reasonable relationship with Class I prices in contiguous states
 - Block price reflects the value of the vast majority of cheese in California
 - The combination of butter/powder and cheese/whey butter is a good measure of overall demand for milk
 - Used successfully in the past
- ❖ One month of commodity prices: for California powder the 11th of prior month to the 10th of current month and for butter and cheese the 16th of prior month to the 15th of current month
 - Lower volatility relative to two weeks of commodity prices
 - Captures more of the market conditions than two weeks of commodity prices, thus harder to manipulate
 - Change from 25th of prior month to 10th and 15th of current month will result in better relationship with Class I prices in contiguous states
- ❖ Butter adjuster reduced from 14.2¢ to 10.5¢
 - Will result in better relationship with Class I component prices in contiguous states
 - Keeps Class 4a issues separate from Class 1 issues
 - The level of the manufacturing cost allowances are not relevant to Class 1 prices
- ❖ CRP differential increased from \$0.494 to \$1.40
 - Reasonable relationship with Class I prices in contiguous states should include the price of moving packaged milk into California and overorder charges received in contiguous states
 - Bulk milk imports are structural in nature and not price related
 - Current packaged milk imports are not significant
 - The one Southern Nevada fluid processor is not a threat to California's market share in Las Vegas
 - Southern Nevada is likely to adopt the "higher of" concept
 - Lower commodity prices and September decision have all lowered producer prices
 - For producers, loss of Class 1 sales will be more than offset by higher prices

- Producers face increased environmental costs
- The CRP takes care of supply/demand issues, thus the CRP differential should be based on a reasonable relationship with Class I prices in contiguous states
- Competition in California's core market should be the main determining factor, not competition in border areas or in contiguous states

*W. Schiek — Dairy Institute of California (Institute), a processor trade association, evidence based on **Alternative, Testimony, Exhibit and Brief***

- ❖ Commodity Reference Price (CRP) higher of Block/Barrel Cheese/Whey Butter or Butter/Powder
 - Reasonable relationship with and better tracking of Class I prices in contiguous states
- ❖ Block/Barrel Cheese to be a weighted average of prices for barrel plus three cents (63%) and block (37%)
 - Block/Barrel tracks federal prices better than block alone
- ❖ Two-week commodity prices: for cheese the period ending the 1st of current month, for butter the period ending the 10th of current month, and for powder the period ending the 15th of current month
 - Change from 25th of prior month to 1st, 10th and 15th of current month will result in better relationship with Class I prices in contiguous states
 - Two-week commodity prices track federal prices better than monthly commodity prices
- ❖ Butter adjuster reduced from 14.2¢ to 9.7¢
 - Will result in better relationship with Class I component prices in contiguous states
- ❖ CRP differential decreased from \$0.494 to \$0.10
 - A price increase is not in the public interest
 - On average, maintains a status quo relative to the current formula
 - Target Northern California Class 1 price equal to Portland, Oregon Class I price, and Southern California Class 1 price equal to Las Vegas, Nevada Class I price (without including overorder charges and hauling costs for packaged milk), this results in a reasonable relation on average
 - Vertically integrated firms do have the option of contracting out for packaged milk or using one of their own out-of-state facilities
 - Hopefully Southern Nevada will adopt the higher of concept
 - Structural changes and mergers in the dairy industry require a more competitive California Class 1 price
 - The recent decline in the CRP (and other class prices) reflects supply/demand issues, the CRP differential should not be increased to try to offset market forces
 - Reserves from past high prices and continuing favorable feed prices should allow producers to weather a period of low prices
 - Backhaul advantage for moving packaged milk into California
 - Class 1 sales are in decline as a result of recent high prices
 - California's Class 1 utilization is lower than any federal order, thus it should have a differential as low as or lower than any federal order
 - High Class 1 prices result in bulk milk imports
 - Class 1 markets are regional not local

- Maintains current competitive relationship between option exempt producer-handlers and other fluid handlers
- Federal compensatory payments may have become more burdensome to California processors

*K. McLaughlin — Security Milk Producers Association, a producer cooperative, evidence based on **Testimony** and **Exhibit***

- ❖ Supports the Alliance/Western proposal in total
 - The one Southern Nevada fluid processor is not a threat to California's market share in Las Vegas
 - Southern Nevada is likely to adopt the higher of concept

*R. Ghilarducci — Humboldt Creamery Association, a producer cooperative, evidence based on **Testimony** and **Exhibit***

- ❖ Supports the Alliance/Western proposal, with the exception that bimonthly pricing is preferred
- ❖ Imperative for processors to maintain competitive pricing with surrounding federal orders
- ❖ Price parity erosion suggests that California processors will lose Class 1 markets to processors in surrounding federal milk marketing orders
- ❖ Implies more raw product is diverted to lower valued commodity products
- ❖ Reasonable relationship takes into consideration what it takes Humboldt Creamery to deliver products to retail stores in comparison with a competitor in a federal order
- ❖ California producers should be paid the highest value attainable in the California class 1 market
- ❖ Bimonthly pricing gave the California dairy industry a distinct marketing advantage over the federal milk marketing orders

*J. Kaczor — Super Store Industries, a fluid milk processor, evidence based on **Testimony**, **Exhibit** and **Brief***

- ❖ Support the proposal made by the Institute
- ❖ Prices for commodities are lowest in areas of greatest supply relative to demand
- ❖ Price alignment is measured by the level of the hundredweight price, the relative levels of the major components of that price, the timing of the price changes, and the amount of the advance notice of the changes
- ❖ Proposals to increase Class 1 prices in California were supported by nothing more than references to problems related to increasing production and decreasing prices
- ❖ One outcome of the recently completed national industry-wide review of milk pricing provisions was the conclusion that class 1 prices should be linked to a measure of the basic value of milk
- ❖ Entire industry has apparently settled on cheese prices as a principal indicator of milk value
- ❖ USDA includes barrel cheese sales prices and volumes, along with block cheese sales prices and volumes, in its index of supply and demand and milk value

- ❖ Cheddar cheese production in the U.S. and in California is about one-third of all cheese production, one-third of that is sold in the form of 40-pound blocks
- ❖ Those who advocate use of block prices only are proposing that data on less than 10 percent of U.S. cheese production be used to price milk for all cheese production and for all Class 1 usage in the U.S.
- ❖ Timing of the announcement of class 1 prices also is a major concern
- ❖ Requested a minimum of ten working days advance notice

*S. Hale — Crystal Cream & Butter Company, a fluid milk processor, evidence based on **Testimony** and **Exhibit***

- ❖ Supports of the testimony presented by the Dairy Institute
- ❖ Out-of-state competition in northern California has been fairly static for the past four months
 - Milk and dairy products from Darigold plants, now West Farm Foods, in Medford and Portland, Oregon, continue to be sold throughout the area
 - Continued presence indicates that California is an attractive market well within their capacity to serve
- ❖ Crystal and McColl's, along with 18 independent distributors, serve the area between Redding and the Oregon border. This is done with milk produced in California
- ❖ Do not return the north state to a negative competitive position as a result of this hearing
- ❖ Class 1 usage has declined to near 20 percent of the total milk used in California
- ❖ Cost of production at the dairy farm level is down from the previous year, and milk production is up significantly
- ❖ Enhance Class 1 prices will add additional benefit for the producer/distributor

*G. Vanden Heuvel, R. Feenstra, N. DeBoom and D. Albers — Milk Producers Council, a producer trade association, evidence based on **Testimony** and **Exhibit***

- ❖ Support both Alliance /Western and Institute as regards higher of for CRP formula
- ❖ Oppose Institute proposal to use barrel cheese in the CRP formula
 - Blocks are a better indicator of supply and demand
 - The historic 3¢ differential between barrels and blocks may no longer hold
- ❖ No position on monthly or two-week commodity prices
- ❖ Support Alliance/Western proposal to increase CRP differential from \$0.494 to \$1.40
 - Increasing environmental costs throughout the state, especially in the Chino Valley
 - Reasonable relationship with Class I prices in contiguous states should include overorder charges received in contiguous states
 - In the past California processors have successfully competed in Las Vegas with a price disadvantage
 - Target Northern California Class 1 price equal to Portland, Oregon Class I price, and Southern California Class 1 price equal to Phoenix, Arizona Class I price (with overorder charges), this results in a reasonable relation on average

*E. Odabashian — Consumers Union, a consumer trade association, evidence based on **Exhibit***

- ❖ Opposes the Alliance/Western proposal
 - Because of the ratchet effect, price increases are not in the public interest
 - There is no reasonably priced nutritional alternative to milk
 - Reasonable relationship with Class I prices in contiguous states does not mean higher prices than other states
 - California has low cost of production
 - May result in Class 1 markets being lost to out-of-state processors

*G. Stueve — Dean Foods, a fluid milk processor, evidence based on **Exhibit***

- ❖ Supports the Institute proposal in total
 - Reasonable relationship with Class I prices in contiguous states
 - California processor need a price that allows them to compete with out-of-state processors
 - Consolidation of processor and retailers, and processing and marketing advances have made a major change in the fluid milk business
 - Price increases will generate a negative consumer image of the dairy industry
 - Las Vegas is an important sales opportunity
 - With production gains, California needs to gain not lose Class 1 markets

*M. Leb — Safeway, Inc., a retail grocery chain with its own fluid processing plants, evidence based on **Exhibit***

- ❖ Supports the Institute proposal in total
 - Reasonable relationship with Class I prices in contiguous states
 - Nevada is a very important market for us
 - Any price increase will lower fluid consumption in California

*J. Bedrosian – Unified Western Grocers (formally Certified Grocers), a wholesale grocery cooperative of independent retailers, evidence based on **Exhibit***

- ❖ Supports the Institute proposal in total
 - Reasonable relationship with Class I prices in contiguous states
 - Las Vegas is a very competitive market for UWG
 - Large overorder charges in Southern California
 - Increase in milk production and cow numbers are not consistent with any proposals for price increases
 - Price increases will generate a negative consumer image of the dairy industry

*D. Parish – Dairy Farmers of America, a producer cooperative, evidence based on **Exhibit***

- ❖ Supports the Alliance/Western proposal in total
 - The current formula does not result in a reasonable relationship with Class I prices in contiguous states
 - Class I prices should including transportation costs for packaged milk

- The higher of for the CRP would result in better a more reasonable relationship with the movement of Class I prices in contiguous states
- Change of commodity prices from 25th of prior month to 10th and 15th of current month will result in better relationship with Class I prices in contiguous states
- Price relief for farmers at a time of low prices

ANALYSIS OF THE HEARING RECORD

Summary of Positions:

The call of the hearing was limited to amendments to the Class 1 pricing formula and the Commodity Reference Price. As such, the January 31, 2000 hearing addressed the same elements of the milk pricing formulas as were addressed in the September 21, 1999 hearing. At the September 21 hearing, the Department made an extensive examination of the competitive price relationship between California's Class 1 farm prices and those in neighboring states that operate under federal milk marketing orders. The analysis performed by the Department and used in the determination of the September 21 hearing remain relevant, applicable, and appropriate for this hearing.

Dairy processors favored adjustments in the Class 1 pricing formula that reduce the cost of unprocessed milk and make California fluid products more competitive with products brought into California by out-of-state processors. With the provisions of federal order reform in place, producers favored increasing Class 1 prices to at least equal to or higher than Class I prices in surrounding states.

Dairy processors and producers agreed conceptually on nearly every amendment to the Class 1 pricing formula with the exception of the Commodity Reference Price (CRP) differential. Both industry groups testified to incorporating a CRP that used the higher value of cheese and whey butter or butter and powder rather than using only the value of cheese. While there were differences in the details, producers and processors also supported the adoption of a more current price data collection period for reflecting commodity values in the Class 1 pricing formula and the reduction of the value of Class 1 fat. Producers and processors disagreed significantly about the level of the CRP differential, which is the single most important amendment proposed that impacts the Class 1 price. Consumers opposed any amendments that would increase milk prices.

With the continued fluctuations in farm milk prices and the finality of Class I milk pricing in federally regulated milk markets, it was necessary to address some of the more elementary issues with the California Class 1 pricing formula. In evaluating the issues raised at the hearing it was appropriate to consider only those pricing issues that are fundamental problems and to set aside those problems and concerns that address more tangential issues for consideration at a later date. In doing so, the Department considered the long-term public interests while balancing the competing interests of producer, processors, retailers, and consumers.

Federal Order Reform:

Effective January 2000, provisions developed by USDA and by Congress were implemented in federal milk marketing orders in the process of satisfying the mandate of the 1996 Federal Agriculture Improvement and Reform Act. There were also major changes to the Nevada State order effective October 1999. The following current characteristics both of federal Class I pricing in adjacent states and of Nevada State Class I pricing are relevant to this hearing:

- Federal Minimum Class I prices are announced monthly;
- Prices are announced on a Fat/Skim Basis;
- Prices are based upon the higher of an advanced Class III price (cheese) or an advanced Class IV price (butter and nonfat dry milk) plus a differential;
- The Class I differentials for adjacent states are:
 - \$1.60 for the Western Order at Burns, Oregon;
 - \$1.75 for the Pacific Northwest Order at Klamath Falls, Oregon;
 - \$1.90 for the Pacific Northwest Order at Portland, Oregon;
 - \$1.90 for the Pacific Northwest Order at Seattle, Washington;
 - \$2.10 for the Arizona–Las Vegas Order at Yuma, Arizona; and
 - \$2.35 for the Arizona–Las Vegas Order at Phoenix, Arizona.
- Nevada State Order Minimum Class I Prices are announced monthly;
- Prices are announced on a Fat/Skim Basis;
- The Class I prices for the Nevada State order are:
 - \$1.40 plus the federal Class III price (cheese only) at Las Vegas, Nevada; and
 - The Northern California Class 1 price at Reno, Nevada.

Adjustment of Fixed Butter Factor in Class 1 Fat Price

Issue:

The current Stabilization and Marketing Plans for Market Milk provide for Class 1 minimum farm prices for each component of milk (fat, solids-not-fat and the fluid carrier, or water). The Class 1 fat price is computed based upon the sales prices for Grade A butter on the CME less the manufacturing cost allowance and freight adjuster times the yield for butter.

The solids-not-fat and fluid carrier prices are calculated as the residual of the Commodity Reference Price minus that fat value calculated above.

Proposals:

Testimony offered at the hearing centered on the appropriateness of the freight adjuster and the manufacturing cost allowance in the Class 1 pricing formula. Particular concern was expressed regarding the implied linkage of the cost of manufacturing butter with the minimum prices calculated under the Class 1 pricing formulas.

Testimony presented by the Dairy Institute supported removing the freight adjuster from the formulas. Their analysis of fat prices in California compared to neighboring states indicated that California's prices were lower. With the solids-not-fat values being the residual of the fat values in both systems, the lower fat prices in California mean that skim values are higher, placing California processors at a competitive disadvantage for lower fat fluid milks.

For differing reasons, both producer and processor representatives favored a fixed butter adjuster that was lower than the existing 14.2 cent combined factor (9.7 cent allowance + 4.5 cent freight adjuster). The petitioners proposed a factor of 10.5 cents, the Dairy Institute proposed 9.7 cents.

Analysis:

The concept of aligning prices includes two separate components. One such component addresses price movements and how well prices move up and down together, but does not necessarily consider the relative price levels. The second component considers the level of prices without regard to the degree to which prices move together. Comparing the differences in fat values between Northern California and the Portland/Seattle markets over the past eighteen months, a fixed butter adjuster of ten cents per pound would have brought California Class 1 fat values into alignment (see table below). Given that the ten cent adjuster falls between the two proposed levels, a fixed, ten cent butter adjuster appears appropriate.

Comparison of Class 1 Fat Prices, October 1998 to February 2000			
	<u>Portland/Seattle</u>	<u>Northern</u>	<u>Difference</u>
	<u>e</u>	<u>California</u>	
October 1998	\$3.04	\$2.97	-\$0.07
November	\$2.91	\$2.86	-\$0.05
December	\$2.43	\$2.51	\$0.08
January 1999	\$1.47	\$1.47	-\$0.01
February	\$1.61	\$1.60	-\$0.01
March	\$1.46	\$1.46	\$0.00
April	\$1.52	\$1.51	-\$0.01
May	\$1.10	\$1.09	-\$0.02
June	\$1.09	\$1.10	\$0.00
July	\$1.63	\$1.68	\$0.05
August	\$1.55	\$1.53	-\$0.02
September	\$1.61	\$1.60	-\$0.02
October	\$1.50	\$1.50	-\$0.01
November	\$1.27	\$1.31	\$0.04
December	\$1.19	\$1.18	\$0.00
January	\$1.00	\$0.98	-\$0.03
February	\$0.95	\$0.93	-\$0.02
<i>Average difference:</i>			<i>\$0.00</i>

Determination:

To set the Class 1 fat price, subtract a fixed adjuster of 10 cents per pound from the calculated butter price and multiply the result by a yield factor of 1.2.

Inclusion of Barrel Cheddar Cheese Prices

Issue:

As dairy commodity markets continue to be volatile, the differences between the California Class 1 and FMMO Class I pricing formulas have become more apparent. In USDA's final decision for federal milk marketing order (FMMO) reform, the new Class I pricing formula contains a reference to the barrel Cheddar cheese price. The FMMO's Class 1 pricing formula will include both block and barrel Cheddar cheese prices with an appropriate weighting adjustment.

Proposal:

The Dairy Institute of California proposed including barrel prices, as well as block prices, in the Commodity Reference Price (CRP) when calculating the California Class 1 minimum farm price. The cheese composite price would be a weighted average using the CME block price times 0.37 and the CME barrel price plus 3 cents times 0.63.

Analysis:

The proposal offers changes to California's CRP that mimic or copy USDA's Class I pricing formula. The inclusion of barrel Cheddar cheese prices in the CRP would add more price information related to Cheddar cheese transactions.

However, it is the price of 40 pound blocks that is used as the standard reference upon which most if not all cheese prices are based. Thus, the addition of Cheddar barrel prices to the CRP would lessen the impact of block prices on the Class 1 price. In addition, the inclusion of barrel cheese prices in the Class 1 pricing formula adds additional complexity without altering Class 1 prices significantly, although the inclusion of barrel cheese prices would not present a burden administratively. The table below compares annual averages for the cheese composite price as testified to by the Dairy Institute and the block cheese price as determined by the Department. Averaged over the six years compared, the cheese composite price was slightly lower than the block only price. Producer groups were opposed to the inclusion barrel cheese prices in the Class 1 formula for this very reason. Increasing the fixed adjuster from the proposed 3 cents to 4 cents would mitigate the price differences, but such an adjustment begs the question of including barrel prices in the Class 1 formula. That is, if the intention of the fixed adjuster is to increase the cheese composite price to the same level as the block price, then perhaps the inclusion of barrel cheese price is not necessary.

The cheese portion of the CRP formula mimics the Class 4a formula, without the manufacturing cost allowance. It would be more consistent to consider including barrels in to the 4b formula before considering its inclusion in the CRP.

Comparison of Barrel and Block Cheese Composite Prices With Block Only Prices ¹					
	<u>Block & Barrel Composite (3 cents)</u>	<u>Block & Barrel Composite (4 cents)</u>	<u>Block Only</u>	<u>Block & Barrel Composite (3 cents) Less Block Only</u>	<u>Block & Barrel Composite (4 cents) Less Block Only</u>
1994	\$1.3037	\$1.3137	\$1.2982	\$0.0054	\$0.0154
1995	\$1.2775	\$1.2875	\$1.2806	-\$0.0031	\$0.0069
1996	\$1.4731	\$1.4831	\$1.4839	-\$0.0107	-\$0.0007
1997	\$1.2673	\$1.2773	\$1.2906	-\$0.0233	-\$0.0133
1998	\$1.4788	\$1.4888	\$1.5140	-\$0.0352	-\$0.0252
1999	\$1.4962	\$1.5062	\$1.4956	\$0.0006	\$0.0106
<i>Average:</i>				<i>-\$0.0110</i>	<i>-\$0.0010</i>

¹ Block and barrel cheese prices are weighted 37% and 63%, respectively, in the formulation of the composites.

Determination:

Barrel Cheddar cheese prices will not be included in the calculation of the CRP at this time.

Use of a “Higher Of” Commodity Reference Price

Issue:

In USDA's final decision for federal order reform, the new Class I price will incorporate a “higher of” concept that, in effect, selects either a cheese-based price mover or a butter and nonfat dry milk-based price mover. The inclusion of a “higher of” concept in the federal pricing formula may contribute toward disparities in price changes between California and federal orders. However, since both the California and Nevada state orders use “cheese only” formulas, there should be no disparities in price changes between these two.

Proposal:

Both producers and processors proposed that the Class 1 formula use a “higher of” CRP. The CRP would use whichever is “higher of” either a cheese-based price mover or a butter and nonfat dry milk-based price mover. Both producer and processors anticipate that later this year, Nevada will adopt a “higher of” mover for pricing in Las Vegas.

Analysis:

In carrying out the directive of the 1996 Federal Agriculture Improvement and Reform Act, USDA announced fundamental changes in the mechanism for pricing milk to be used for fluid purposes. The Class I pricing formula released in USDA's final decision selects the “higher of” either a cheese-based price mover or a butter and nonfat dry milk-based price mover.

The proposals of both producers and processors suggest changes to California's CRP that attempt to mimic or copy USDA's Class I price mover in its reform package. Adoption of the “higher of” would improve the degree to which California Class 1 prices would move with federal order reform milk prices.

The concept of aligning prices includes two separate components. One such component addresses price movements such that prices move up and down together, but are not necessarily at the same level. The second component considers the level of prices without regard to the degree to which prices move together. By reworking the current CRP, California Class 1 prices can be made to move up or down at the same time as Class I prices in surrounding markets without the addition of more factors to the pricing formula.

The Department used a “higher of” CRP prior to 1997. However at that time, federal orders tied their Class I prices to “cheese only”. Because of major misalignments in movements between California and federal order prices, the Department changed its CRP to a “cheese only” formula. The original California “higher of” CRP had been developed to provide better alignment of the California Class 1 prices with California Class 4a and 4b prices. With federal orders adopting a “higher of”, it is appropriate for California to consider readopting this concept.

A “higher of” CRP will tend to raise average milk prices. Currently, feed prices are low, and milk production is rapidly increasing. Thus, adoption of a “higher of” CRP requires a careful review of the CRP differential, currently \$0.494 per hundredweight.

Determination:

The “higher of” concept for a price mover will be included in the CRP at this time. However, should the Nevada state order fail to adopt a “higher of” mover for Las Vegas, the use of a “higher of” CRP in California will need to be reexamined. The issue of an appropriate CRP differential is addressed in a later section in these determinations.

Alter Method for Collecting Commodity Price Data By Shortening Window and Using More Recent Price Data

Issue:

In California, the Class 1 price in the current month is calculated from dairy commodity price data that is collected from the 26th of the third prior month to the 25th of the second prior month. The final rule issued by USDA in the process of reforming federally regulated milk markets changed the entire process of calculating a Class I price, including the window during which relevant commodity price data is collected. The objective was to move to a pricing system that uses the most current commodity price data. To meet this goal, USDA relies the most current pricing data for a two-week period available by the 23rd of the prior month.

In the past, a review of comparable monthly commodity price data used by the California and federal milk marketing orders shows that extreme differences can occur, especially during periods in which dairy commodity prices are volatile. Clearly, the change brought about by federal milk marketing order reform only exacerbates the problem of dissimilar commodity prices and, consequently, dissimilar minimum prices for milk used for fluid purposes.

Proposals:

Two proposals were advanced at the hearing that offered different options to alter the existing price data collection period used in the calculation of the Class 1 price. One proposal uses the simple average of the daily trading or sales falling between the 16th of the second prior month to the 15th of the prior month for butter and cheese. For nonfat dry milk, the proposal uses the weighted average from California powder sales from the 11th of the second prior month to the 10th of the prior month. The other proposal uses separate data collection periods for each of the three commodities: for cheese, the most recent two-week period as of the 1st of the prior month; for butter, the most recent two-week period as of the 10th of the prior month; for nonfat dry milk, the two most recent weekly reports of California powder sales as of the 15th of the prior month.

Analysis:

Proposals to change the existing price data collection period attempt to improve the alignment between California's prices with those in adjacent states. In this case, alignment refers to the degree to which prices in the two regulatory systems move together and does not address the actual price level differences that may exist. Because federally regulated markets use a shorter and more recent window of data, California prices will align better with the movement of prices in adjacent states if a similar data collection period is implemented.

While a shortened data collection period would improve how prices track, it would not fully reflect the activity of the commodity markets. It would also shorten the advance notice to processors of price changes, but both proposals would provide Class 1 processors with adequate notice of price

changes. Furthermore, fluid processors will get more advanced notice than they did from 1978 to 1993 under the three-factor formula, which usually resulted in price change announcements 15 days in advance.

Changing the price data collection period will reduce the incidence of price inversions with California's own prices, i.e., the Class 4b price would be less likely to exceed the Class 1 price in any particular month.

From an economic view, there is an appeal to using input data (commodity price data) that is more current. One proposal reduces the number of price observations so that only the most recent trading information is used for pricing Class 1 milk. However, it should be recognized that there is a trade-off between using fewer commodity price observations and inviting some volatility into price calculations. The table below verifies that there are only minor commodity price differences among the three data collection periods reviewed.

Price Comparisons Using Different Data Collection Periods					
	Dairy Institute	Alliance/ WUD	Department	Department less Dairy Institute	Department less Alliance/ WUD
Butter Price Comparisons					
1994	\$0.7016	\$0.7012	\$0.7016	\$0.0000	\$0.0004
1995	\$0.8002	\$0.7921	\$0.8002	\$0.0000	\$0.0081
1996	\$1.0842	\$1.0893	\$1.0842	\$0.0000	-\$0.0051
1997	\$1.0932	\$1.0869	\$1.0932	\$0.0000	\$0.0064
1998	\$1.7781	\$1.7717	\$1.7781	\$0.0000	\$0.0064
1999	\$1.2822	\$1.2856	\$1.2809	-\$0.0013	-\$0.0047
Block Cheese Price Comparisons					
1994	\$1.3005	\$1.2962	\$1.2982	-\$0.0023	\$0.0020
1995	\$1.2796	\$1.2801	\$1.2806	\$0.0010	\$0.0005
1996	\$1.4880	\$1.3823	\$1.4839	-\$0.0041	\$0.1015
1997	\$1.2807	\$1.2867	\$1.2906	\$0.0099	\$0.0039
1998	\$1.5010	\$1.5144	\$1.5140	\$0.0129	-\$0.0004
1999	\$1.5128	\$1.4957	\$1.4956	-\$0.0171	-\$0.0001
Nonfat Dry Milk Comparisons					
1994	\$1.0519	\$1.0532	\$1.0530	\$0.0012	-\$0.0002
1995	\$1.0445	\$1.0439	\$1.0439	-\$0.0006	\$0.0000
1996	\$1.1620	\$1.1543	\$1.1536	-\$0.0083	-\$0.0007
1997	\$1.0841	\$1.0903	\$1.0868	\$0.0027	-\$0.0035
1998	\$1.0429	\$1.0423	\$1.0431	\$0.0002	\$0.0008
1999	\$1.0227	\$1.0246	\$1.0235	\$0.0009	-\$0.0011

Administratively, a change from the current data collection period has few drawbacks, and most of the potential problems relate to the collection of nonfat dry milk price data. The shorter data collection window and the "floating" dates for collecting NFDM prices may be more challenging than the current method for collecting price data. Credits given to NFDM distributors/processors

will be less of a complicating factor when collecting NFDM price data. However, the credits will continue to be an issue with the monthly NFDM price as is used in Class 4a price calculations.

Determination:

To set the Class 1 price in the current month, use CME commodity price data observed from the 26th of the second prior month through the 10th of the prior month for butter and cheese, and the weighted average of the two most recent weekly reports of California powder sales available as of the 10th of the prior month.

Commodity Reference Price Differential and Class 1 Price Level

Issue:

Dairy processors have testified in recent hearings that changes in the competitive environment make Class 1 price alignment with neighboring states a more crucial issue than it was years ago. During this hearing, processors testified that: (1) there are an increased number of regional and national milk processing and retailing firms, operating within and outside of California, and (2) changes in transportation structures and the logistics of large retailers have increased the potential to replace California's fluid milk production with processed and unprocessed milk from outside the state and have increased the distances that milk is moving to retail operations from the processing plants.

Dairy producer representatives testified at recent hearings that a higher Class 1 price than those in neighboring states is reasonable. They argued at this hearing that: (1) milk prices have fallen to very low levels, (2) there are added on-farm economic expenses due to increased environmental requirements, and (3) farmers should not be penalized for their productive efficiency.

Proposals:

For January 2000, the butter/powder-based CRP was approximately \$1.60 per hundredweight higher than the cheese-based CRP. Consequently, the adoption of the "higher of" concept for determining the appropriate CRP in the Class 1 price formula is projected to increase the Class 1 price substantially for the April pricing period.

The policy instrument that directly influences the impact of the monthly change in commodity reference price is the CRP differential. The differential is added to the monthly CRP to determine the actual hundredweight price level. The current CRP differential is \$0.494 per hundredweight. There were two basic proposals presented at the hearing regarding the CRP differential. One would have decreased the CRP differential to \$0.10 per hundredweight, while the other would have increased it to \$1.40 per hundredweight.

Analysis:

At the September 21, 1999 hearing, the Department made an extensive examination of the competitive price relationship between California's Class 1 farm prices and those in neighboring states that operate under federal milk marketing orders. The Department's analysis in its determination of the September 21 hearing relating to "Production Costs and Milk Prices", "Production and Production Capacity", "California Exports and Imports of Unprocessed and Package Milk", "Utilization", "Federal Order Reform and the Cornell Model", and "Competitiveness" remain relevant, applicable, and appropriate for this hearing.

The Department made a significant improvement in the competitiveness of California Class 1 products by reducing the CRP differential in the pricing formula by 57 cents per hundredweight from approximately \$1.06 to \$0.49 per hundredweight.

As the Dairy Institute testified:

“The changes to the Class 1 Pricing formulas that were made as a result of the September 1999 Class 1 hearing addressed many of the concerns that Dairy Institute members had with the prices generated by the previous Class 1 formula. In particular, California prices were adjusted so that raw product costs for whole milk, reduced fat, lowfat, and nonfat milk track more closely with the cost for the same products in federal orders. This was done by adjusting the formula so that both Class 1 fat and skim (solids not fat plus fluid carrier) prices in California tracked more closely with the price of those components in surrounding states. This was a significant change and one that significantly improved the competitive position of California processors.

The other major change resulting from the last hearing was a reduction in the basic level of Class 1 Prices, a change that was needed to restore California prices to reasonable alignment with prices in surrounding markets. Prior to recent formula changes, Class 1 prices in Southern California for milk testing 3.5% fat, 8.7% solids not fat (SNF) were averaging \$1.06 higher than Las Vegas and 12 cents higher than Phoenix. Northern California prices were about 47 cents higher than Portland prices during the June 1997–December 1999 period. If the current Class 1 formula had been in effect for the same period, Southern California Class 1 prices would have averaged 41 cents higher than Las Vegas and 53 cents lower than Arizona on a hundredweight basis (3.5% fat, 8.7% SNF). Northern California prices would have averaged 18 cents lower than Portland prices during the June 1997- December 1999 period.”

The changes were announced as being made effective on November 1, 1999. However, legal action delayed implementation until December 1, 1999.

During the interim, there has been a substantial change in federal Class I pricing formulas for neighboring states. The new concept of using the “higher of” value of cheese or butter/powder as the principal means of adjusting the price level became effective as of January 2000. This had the effect of increasing the Class I prices in neighboring states that operate under the federal program. A comparison of California’s minimum price with neighboring states reflect that California prices were higher prior to December 1999 and substantially lower after December 1999 (see table).

If the Department’s changes had been in effect during a prior period, Northern California’s Class 1 price would have been slightly higher than the Pacific Northwest federal order prices, while the Southern California’s Class 1 Price would have been lower than the Central Arizona federal order price level. Adoption of the Dairy Institute proposal would lower Northern California price level relative to the Pacific Northwest and lower the Southern California Class 1 Price relative to Central Arizona.

California and Federal Order Fluid Milk Prices, Dollars per Hundredweight ¹					
<u>Northern California</u>	<u>Pacific Northwest</u>	<u>Difference</u>	<u>Southern California</u>	<u>Las Vegas – Arizona</u>	<u>Difference</u>

August, 1999	\$14.61	\$13.32	\$1.29	\$14.88	\$13.94	\$0.94
September	\$14.61	\$15.49	-\$0.88	\$14.88	\$16.11	-\$1.23
October	\$19.53	\$17.69	\$1.84	\$19.80	\$18.31	\$1.49
November	\$19.53	\$18.16	\$1.37	\$19.80	\$18.78	\$1.02
December	\$13.70	\$13.39	\$0.31	\$13.97	\$14.01	-\$0.04
January, 2000	\$11.92	\$12.80	-\$0.88	\$12.20	\$13.25	-\$1.05
February	\$11.69	\$12.61	-\$0.92	\$11.96	\$13.06	-\$1.10

¹ California prices changed effective December 1999, Federal Order Reform prices effective January 2000.

The adoption of Dairy Institute's \$0.10 CRP differential, coupled with the adoption of the higher of concept, would increase the absolute price level. Amending the current CRP differential from the current \$0.494 to \$0.10 per hundredweight lowers the Class 1 price (whole milk) by \$0.394. Significant changes to the CRP differential were made as a result of the September 21, 1999 hearing to bring the level of California Class 1 prices down to the level of prices in surrounding states. It is premature to consider reductions that would alter the price relationship established in the last hearing just five months ago. There have been no material changes in the way that milk is produced, processed, distributed or marketed that would warrant changing the established price relationship. A slight decrease (\$0.03) of the current CRP differential maintains the competitive price relationship established as a result of the September 21, 1999 hearing.

In a similar vein there was no economic justification within the hearing record to significantly increase the CRP differential in the Class 1 pricing formula. To do so would be inconsistent with the determination of the previous hearing and would be detrimental to the long term interests to producers, processors and consumers of California. The Department strongly believes that adoption of the Western United/ Alliance of Milk Producer proposal would result in inappropriate and noncompetitive Class 1 Prices.

Determination:

Given the above analysis, decreasing the CRP differential to \$0.464 in California's Class 1 pricing formula is warranted and appropriate. The decrease in the CRP differential will maintain the price relationship with surrounding states as established in the determinations from the September 21, 1999. The adjustment to the CRP differential does not raise California milk prices above those in surrounding federally regulated milk markets and will help keep California fluid milk products competitive with other milk supplies. In accord with Section 62062.1, the adjustment to the CRP differential keeps minimum Class 1 prices paid to California producers in reasonable relationship with minimum Class 1 prices paid to producers in contiguous states.

SUMMARY OF DETERMINATIONS

As a result of the testimony and evidence received during the hearing process, the Department will make the following amendments to the Milk Stabilization and Marketing Plans for Northern and Southern California:

For the calculation of the Class 1 price,

- Use the higher of the Commodity Reference Price based on butter and nonfat dry milk or cheese and whey butter.
- Use CME commodity price data observed from the 26th of the second prior month through the 10th of the prior month for butter and cheese, and the most recent two weekly reports for California NFDM available as of the 10th of the prior month.
- Replace the freight adjustment and manufacturing cost allowance in the Class 1 fat price formula with a fixed adjuster equal to 10 cents per pound.
- Decrease the Commodity Reference Price differential from \$0.494 to \$0.464 per hundredweight.

EFFECTS OF PANEL RECOMMENDATION

Producers:

Using Department's determinations during the period October 1998 through March 2000, pool prices paid to producers would have been an average of \$0.11 per hundredweight higher when compared to prices calculated by using the current formula and projecting backward. Monthly averages ranged from a low of -\$0.48 per hundredweight to a high of \$0.66 per hundredweight.

Processors:

Using Department's determinations during the period October 1998 through March 2000, the average cost for whole milk would have been \$0.51 per hundredweight higher. Across all fluid milk types, the average cost would have been \$0.54 per hundredweight higher.

Consumers:

Consumers will likely see higher milk prices because processors will pass their raw product price increases along to retailers, and retailers will attempt to recoup product price increases by raising retail prices. The increase in retail prices attributable to the Department's decision averages 4.4¢ per gallon of whole milk over the period October 1998 through March 2000. Monthly averages ranged from a low of -22¢ per gallon to a high of 25¢ per gallon.

Public:

There will be a general public detriment from increasing milk prices, although the Department's amendments will improve alignment of California's milk prices with those in surrounding states. The \$0.51 per hundredweight (4.4¢ per gallon) increase in milk prices is significant. However, an increase of this magnitude keeps milk prices in California in a closer relationship with milk prices in Oregon, Nevada and Arizona.

SUMMARY OF CLASS 1 PRICING FORMULA

- Cheese prices (block only) — From the Chicago Mercantile Exchange (CME), the 26th to the 10th of the prior month.
- Butter prices — From the CME, the 26th to the 10th of the prior month.
- NFDM prices — The two most recent California weighted average quotes available as of the 10th of the prior month.

Statewide

$$\text{CRP} = \text{Higher of } (\text{Cheese} \times 9.8) + (\text{Butter} - \$0.10) \times 0.27 \quad \underline{\text{Or}} \\ (\text{Butter} \times 1.2) \times 3.5 + (\text{NFDM} \times 0.99) \times 8.7$$

$$\text{Fat} = (\text{Butter} - \$0.10) \times 1.2$$

$$\text{SNF} = ((\text{CRP} + \$0.464) - (\text{Fat} \times 3.5)) \times 0.76/8.7$$

$$\text{SC Fluid} = ((\text{CRP} + \$0.464) - (\text{Fat} \times 3.5)) \times 0.24/87.8$$

$$\text{NC Fluid} = ((\text{CRP} + \$0.464) - (\text{Fat} \times 3.5)) \times 0.24/87.8 - \$0.0031$$

FINDINGS OF THE DEPARTMENT OF FOOD AND AGRICULTURE

The Department of Food and Agriculture makes the following findings based upon the testimony and evidence presented at the public hearing held on January 31, 2000 in Sacramento, California.

The Department has considered all testimony and items of evidence submitted by all parties to these proceedings, whether specifically mentioned herein, in rendering these findings. The Department has considered all provisions set forth in Chapter 2, Part 3, Division 21 of the Food and Agricultural Code, whether specifically mentioned herein, in rendering these findings. These include, without exception, all provisions and declarations regarding public interest considerations.

It is hereby found and concluded that:

- (1) The current Stabilization and Marketing Plans for Market Milk now in effect are no longer in conformity with the standards prescribed in and will not tend to effectuate the purposes of said Chapters 2 and 3.
- (2) The amendments contained in Stabilization and Marketing Plan for Market Milk for Northern California Order Number 40 and the Stabilization and Marketing Plan for Market Milk for Southern California Order Number 55 shall become effective as of 12:01 a.m. on April 1, 2000.
- (3) The above referenced changes included in the Stabilization Plans for Market Milk will tend to accomplish the purposes of said Chapter 2 within the standards therein prescribed.

ORDER OF THE SECRETARY OF FOOD AND AGRICULTURE

Therefore, I order that the Stabilization and Marketing Plan for Market Milk for Northern California Order Number 40, and the Stabilization and Marketing Plan for Market Milk for Southern California Order Number 55 shall become effective at 12:01 a.m., April 1, 2000.

Tad Bell, Deputy Secretary
California Department of Food and Agriculture

Signed and entered in
the Office of the Secretary
of Food and Agriculture at
Sacramento, California,
on March 21, 2000